IN THE MATTER OF THE APPLICATION REGARDING CONVERSION
OF PREMERA BLUE CROSS AND ITS AFFILIATES

Washington State Insurance Commissioner's Docket # G02-45

PRE-FILED DIRECT TESTIMONY OF:

Jerry E. Lusk
Milliman USA

March 31, 2004

I. INTRODUCTION

Q. Please state your name.

A. My name is Jerry E. Lusk.

Q. Please state your position and business address.

A. I am a Consulting Actuary and a Principal with Milliman USA, Inc. ("Milliman"). I work out of Milliman's Atlanta office. Our address is 945 E. Paces Ferry Road NE, Suite 2500, Atlanta, GA 30326.

II. SUMMARY OF TESTIMONY

Q. Please provide us with an overview of your expert testimony.

A. We were asked by PREMERA, Premera Blue Cross, and certain of their affiliates (collectively "Premera") to evaluate the likely premium rate impact, if any, of the conversion of Premera. To do so, we modeled the margins and resulting premium rates under two scenarios and projected both scenarios through the year 2008. Scenario 1 was "Without Conversion" and Scenario 2 was "With Conversion."

We concluded that Premera's conversion is not likely to result in any material impact on its premium rates.

Comparing the results under the two scenarios, we found that the modeled premium rates over the next five years do not vary significantly between the two scenarios. Indeed, the premium rates in the "With Conversion" scenario would be slightly lower -- by 0.5% -- than the premium rates in the "Without Conversion" scenario.

We also found that rating margins in the current Premera premium rate projections are generally not sufficient to meaningfully increase Premera's surplus in relation to its RBC benchmarks and that, other than a relatively small increase in the Alaska premium tax, the conversion is unlikely to generate changes in the components of Premera's premium rate structure.

III. PROFESSIONAL QUALIFICATIONS

Q. Tell us about the work that your firm, Milliman, does.

A. Milliman is an independent consulting firm that began in Seattle in 1947. The firm is an internationally recognized leader in the actuarial consulting industry.

Q. How long have you been with Milliman?

A. I joined Milliman in 1977. I left in 1986 to serve as Chief Financial Officer at Blue Cross Blue Shield of Georgia. I then returned to Milliman in 1989, where I am now a Consulting Actuary.

Q. Please describe your education and qualifications.

A. I received a Bachelor of Science degree in Applied Mathematics and Business Administration from the University of Colorado in 1970. I then received an MBA from the University of Dayton in 1973.

Q. Are you an accredited actuary?

A. I am. I am a Member of the American Academy of Actuaries (MAAA). I'm also a Fellow of the Conference of Consulting Actuaries (FCA). I take continuing education programs each year so as to meet the requirements of the American Academy of Actuaries, which are necessary to be able to sign public statements of actuarial opinion.

Q. Are you the author of any books?

A. I was an Associate Editor of the textbook, "Group Insurance." I also wrote a chapter in that textbook, dealing with multiple-choice environments in which individuals have a choice between insurance plans with different characteristics.

Q. Describe the range of your work experience at Milliman.

A. I've worked extensively with Blue Cross/Blue Shield plans, HMOs, PPOs, health insurance carriers, provider organizations, and benefit plan sponsors. My consulting work has included product design and reporting, financial forecasting and analysis, surplus management, strategic planning, analysis of actuarial liabilities, development of provider risk sharing arrangement, and many other aspects of risk management. I've also had experience with developing and supporting managed care organizations.

Q. Do you have a biography that summarizes your educational, professional and employment history?

A. Yes. A true and correct copy of my biography is attached hereto as **Exhibit A** and incorporated herein by reference; it will be marked as a Premera Hearing Exhibit.

IV. MILLIMAN'S EXPERT REPORTS

Q. Have you submitted expert reports in this proceeding?

A. Yes. Milliman filed a report entitled "Premera Comparative Premium Rate Analysis," dated November 10, 2003. I submitted a copy of this report, with a few non-material corrections to it, as an attachment to the corrections page for my deposition. A copy of the Milliman Report with those corrections (hereinafter, the "Milliman Report") will be marked as a Premera Hearing Exhibit.

We also filed a Supplement, dated March 5, 2004 (the "Milliman Supplemental Report"). This will also be marked as a Premera Hearing Exhibit.

I hereby incorporate the Milliman Report and the Milliman Supplemental Report into this Pre-filed Direct Testimony by reference.

V. DETAILED TESTIMONY

Q. What was Milliman's approach to determining whether Premera's premium rates were likely to change as a result of the proposed conversion?

A. To evaluate whether Premera's premium rates are likely to change as the result of the proposed conversion, we reviewed the components of Premera's premium rate structure and assessed the probable impact of the conversion on these components. Our analysis involved a comparison of modeled margins and premium rates under two scenarios: Scenario 1 is the current Without Conversion environment, and Scenario 2 is the simulated With Conversion environment. Section 2 of the Milliman Report describes this methodology in detail.

A. Premera's Premium Rate Structure

Q. What are the components in Premera's premium rate structure?

A. The premium rate components are discussed in detail in Section 3 of the Milliman Report. In summary, the components are:

- Health Care Costs – This is the dominant component in any health insurance premium rate and reflects the cost of health care services provided to insured members.

- General Administration Expenses – Typically the second largest component, general administration expenses include the company's fixed and variable operating expenses.

- Broker Commission Expense – This component reflects the commission expenses paid to brokers and/or consultants for selling and/or servicing insurance coverage to a member or insured group.

- <u>Premium Tax</u> – This is a state tax imposed on health insurance premiums; the tax is directly payable to the state by each insurance company. In Washington, the current premium tax is equal to 2% of insurance premiums. The premium tax in Washington will not be affected by conversion, though a slight composite increase is expected in Alaska.

- <u>Health Insurance Pool Assessment Expense</u> – This is an assessment for the company's pro-rata subsidy of the state's High Risk Pool ("HRP"). The HRP offers health insurance coverage to individuals who are not eligible to purchase health insurance coverage directly through licensed insurance companies. The HRP premium rates are subsidized by an assessment on each company selling coverage in the state. The basis of the assessment reflects the relative business volume of each health insurance company doing business in the state.

- <u>Interest Credit</u> – This component reflects the interest income earned on the portion of the premiums earmarked for claims that are incurred but not paid. There is generally a time gap between the date a medical service is performed and the date the associated claim is paid. Premera reduces premiums to reflect interest earned on this "float."

- <u>Contingency & Risk</u> – The C&R component of the premium rate provides for a) the risk of uncertainty of future events (contingency) and b) return on capital employed. C&R charges help build necessary surplus to weather unexpected contingencies that could otherwise result in financial impairment. C&R charges are also referred to as "margins". The accumulation of adequate surplus is critical to the ongoing viability of any health insurance entity.

Q. Can these components be represented graphically?

A. Yes. The primary components of Premera's premium rate structure are illustrated graphically (but not to scale) on page 2 of the Milliman Report.

B. The Two Scenarios

Q. Please describe your analysis of the "Without Conversion" scenario.

A. Our analysis of the Without Conversion scenario involved a 3-step process:

- Step 1: Surplus Benchmark – We modeled the necessary and appropriate level of surplus required for Premera to remain viable after absorbing significant financial losses. Our analysis of appropriate surplus is based on the concept of Risk Based Capital ("RBC"). It is also based on observed financial results for Premera and similar companies where losses have occurred over a prolonged period.

- Step 2: Margin Requirement - We calculated the average rating margin needed over the 5-year period ending in 2008 for Premera to achieve the surplus benchmark calculated in Step 1.

- Step 3: Premium Rates – We then calculated the average premium rates for Premera's insured business during the 5-year period based on the margin calculated in Step 2.

Q. Describe your analysis of the "With Conversion" scenario.

A. Our analysis of the With Conversion scenario involved the same 3-step process:

- Step 1: Surplus Benchmark - We used the same surplus benchmark from the Without Conversion Scenario.

- Step 2: Margin Requirement – We calculated the average rating margin needed over the 5-year period ending in 2008 for Premera to achieve the surplus benchmark from Step 1. The projection assumptions used in this process include changes in rating components (e.g. Alaska premium tax) and investable assets that can reasonably be expected to result from the conversion.

- Step 3: Premium Rates - We then calculated the average premium rates for Premera's insured business during the 5-year period based on the margin calculated in Step 2.

Q. How did you compare the two scenarios?

A. The final step in our analysis was to compare the average premium rates calculated under the two scenarios. The premium rates under both scenarios are roughly equivalent; rates from the With Conversion scenario are slightly lower. The lower rate levels in the With Conversion scenario are due to an increase in assets and investment income, which more than offsets the increase in Alaska premium tax. This results in a lower modeled margin than under the Without Conversion scenario. This comparison is summarized in the "Summary of Findings" and discussed in more detail in Section 4 of the Milliman Report.

Q. What were your findings?

A. Based on our analysis and a comparison of the results under the two scenarios, we found that the components of the premium rate structure (described above and discussed in more detail in Section 3 of the Milliman Report) are not likely to vary significantly between the two scenarios. Modeled premium rates over the next five years do not differ significantly between the two scenarios: the premium rates in the "With Conversion" scenario would be slightly lower -- by 0.5% -- than the premium rates in the "Without Conversion" scenario.

C. Analysis of Rating Margins

Q. Are rating margins in current Premera premium rate projections sufficient to increase Premera's surplus in relation to RBC benchmarks?

A. No. Rating margins included in current Premera premium rate projections are generally not sufficient to increase Premera's surplus meaningfully in relation to RBC benchmarks. In the absence of a conversion, margins would have to increase in order to accumulate a surplus level that would adequately guarantee coverage for the groups and members served by Premera. Plan management has focused on achieving adequate surplus during the past several years. However, due to market constraints and the need to invest in infrastructure, Premera has not been able to increase margins to the levels necessary to build adequate surplus.

D. Time Period for Washington Economic Impact Assurances

Q. Did you review a document entitled, "Washington Economic Impact Assurances," that was part of Exhibit E-8 to Premera's Amended Form A?

A. I did. Our analysis regarding Premera's Amended Form A is set forth in the Supplemental Report.

Q. The termination date for the Assurances is two years. What is your conclusion about any time requirement beyond two years?

A. We conclude that it would not be practical or prudent for any health insurer to agree to make rate-related assurances that extend beyond a 1 to 2 year period, particularly if competitors are not bound by similar assurances.

It is important to note that the two year term already has the effect of limiting rating actions and strategies for close to a three year period. This is because, since most of Premera's business renews on a 12-month rating cycle, the impact of the two year term would carry over into the third year after conversion.

Q. So do you disagree with PwC's recommendation that the Assurances should be in place for "a minimum period of three years?"

A. We disagree with PwC's recommendation. It would be an unsound business practice and imprudent for a company to make a rate-related assurance for three years. Especially when its competitors are not so handcuffed.

<u>E. The ASC Business Line</u>

Q. In PwC's February 27, 2004 Report Addendum on its Economic Impact Analysis, PwC concludes: "Among the ASC business line in particular . . .the current expense allocation model suggests that administration charges would have to increase significantly to reach target margins without subsidization from other product lines."

Do you agree with PwC's conclusion?

A. No. Our conclusion is that Premera has acted prudently with regard to its pricing strategies for the ASC business line.

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Q. Does this conclude your pre-filed direct testimony?

A. Yes.

VERIFICATION

I, JERRY E. LUSK, declare under penalty of perjury of the laws of the State of Washington that the foregoing answers are true and correct.

Executed this ____ day of March, 2004, at ____________, _________________.

/s/

JERRY E. LUSK

Biography

Jerry E. Lusk MAAA, FCA
Consulting Actuary

Current Responsibility

Jerry is a Principal with the Atlanta office of Milliman USA. He joined the firm initially in 1977 and again in 1989 after serving three years as Chief Financial Officer at Blue Cross Blue Shield of Georgia.

Experience

Jerry has worked extensively with Blue Cross/Blue Shield plans, HMOs, PPOs, health insurance carriers, provider organizations, and benefit plan sponsors. His client activities have included product design and reporting, financial forecasting and analysis, surplus management, strategic planning, analysis of actuarial liabilities, development of provider risk sharing arrangements, and all other aspects of risk management. He has also worked extensively in the development and ongoing support of managed care organizations.

Professional Designations

- Member, American Academy of Actuaries
- Fellow, Conference of Consulting Actuaries

Honors

Jerry is frequently asked to speak on various topics involving health insurance and managed care. Recent speaking engagements include the American Association of Healthcare Attorneys annual meeting, the BCBS of Georgia annual board retreat, and various meetings on home healthcare. He co-edited and co-wrote the textbook *Group Insurance*. He has also served on Milliman's Health Steering Committee for more than four years.

Education

BS, Applied Mathematics and Business Administration, University of Colorado
MBA, University of Dayton

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